

Canada Offers A Gift To Inflation Doves

- **Headline inflation was unchanged and lower than consensus...**
- **...but core inflation edged lower in December and through revisions**
- **Slack and waning idiosyncraties should pose future downside risk**
- **BoC's print communications will be unaffected...**
- **...but expect Poloz to be asked about the latest readings in the presser**
- **The BoC's core measures include key idiosyncratic, temporary drivers**

Canada, CPI m/m % / CPI y/y %, NSA, December:

Actual: 0.0 / 2.2

Scotia: -0.3 / 2.1

Consensus: 0.0 / 2.3

Prior: -0.1 / 2.2

Canada, Core Inflation y/y %, December:

Average: 2.1 (revised down to 2.1 from 2.2)

Weighted Median: 2.2 (revise down to 2.3 from 2.4)

Common Component: 2.0 (1.9)

Trimmed Mean: 2.1 (2.2)

Ahead of the Bank of Canada, core inflation edged lower not only in December but also through the effects of revisions to the prior month. The BoC can still point to core inflation being roughly on-target, but with slightly lowered conviction about the magnitude and direction of the changes. On a trend basis, more of this is expected over 2020. This has zero bearing on the already set 10am communications from the BoC; if it matters at all, it may influence the tone in the press conference and it's likely that Poloz will be asked whether the slightly softer than expected pressure will have legs going forward.

Average core ticked down to 2.1% y/y in December and the slight downward revision to weighted median CPI was enough to swing the arithmetic average of the three core measures back down to 2.1% in November from the initially reported 2.2% rate. Chart 1 shows the present estimates of year-over-year average core inflation with the lower peak in November. Chart 2 shows the breakdown of the three core measures.

There are two main reasons for why core inflation is likely to face continued downside risk. One is that slack has widened. More important in my opinion is that the top drivers of inflation on a weighted contribution basis are likely transitory and idiosyncratic as previously written.

To that effect, chart 3 shows the weighted contributions to year-over-year headline CPI ranked from top to bottom in percentage points. Gasoline, rent (driven by replacement cost which is driven by the house only component of new house prices), mortgage interest (driven by the 2018 hikes...), and auto insurance were the top drivers this month. Vehicles were also up there as CAD's lagged depreciation from 2018 into the 2019 model year impacted vehicle prices and premiums that are partly keyed off prices. As CAD appreciated in 2019, auto prices and premiums should level out. As the BoC held its policy rate over 2019, mortgage interest should drop out. As new home prices have softened, rent should also level out.

CONTACTS

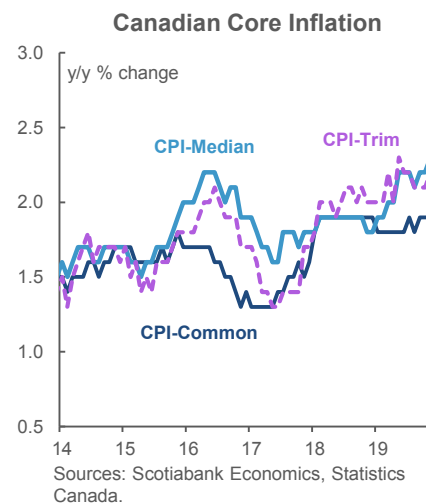
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Chart 1



Chart 2



In terms of what drove CPI on a month-ago seasonally unadjusted basis, chart 4 shows the weighted contributions ranked from top to bottom. Get used to the top driver: Airfare. One reason for this is that StatsCan revised its methodology again in the November figures and uses different methods for collecting daily prices while capturing more destinations and now all airlines serving the Canadian market. Further, Boeing's issues are likely continuing to drive airfare higher. In fact, with domestic airlines now extending suspension of the 737Max plane to June 30th, there will be little relief in airfare premiums for some time as airlines scramble to adjust prices for less near-term capacity. The BoC would (I hope...) look through this distortion as temporary and driven by idiosyncratic factors beyond the control of monetary policy. Beyond airfare, grocery and new housing contributions also led the month-ago changes in CPI.

As for the 0.4% m/m SA rise in headline inflation (versus 0.0% m/m NSA), I would look past it. Transportation and mostly gas prices drove it with a 0.5% m/m jump. Everything else was considerably softer with gains in the 0.1-0.3% zone and with a pair of declines in household ops/furnishings/equipment and the 'sins' category

Chart 5 on the next page breaks down what was included in the December basket for trimmed mean CPI on a month-ago seasonally adjusted basis in order to give a spot sense of what was included in the latest month. The included components are shaded green whereas the excluded top and bottom 20% of the basket are shown in shades of blue. The top contributors in terms of what was included in the basket included passenger vehicle operating costs and utilities.

Chart 6 shows the number of times each of the 55 components in CPI were included within the trimmed mean CPI basket over the past twelve months, given that trimmed mean arrives at the year-ago rate by compounding the monthly rates of change in the core 60% of the basket. I use it to demonstrate the fallacy to the belief that the core measures weed out potentially transitory and idiosyncratic drivers that are standing out. Auto parts prices, for instance, have been in the trimmed mean monthly basket for every single month. So have property taxes. Auto prices themselves have been in the basket for 8 of the 12 months. Mortgage interest has been included for half of the year's months. None of these components are output gap considerations versus being driven by idiosyncratic factors that are judged to be transitory and so if they are distorting the basket, then that's a dent against the usefulness of the core measures in relating them to spare capacity considerations.

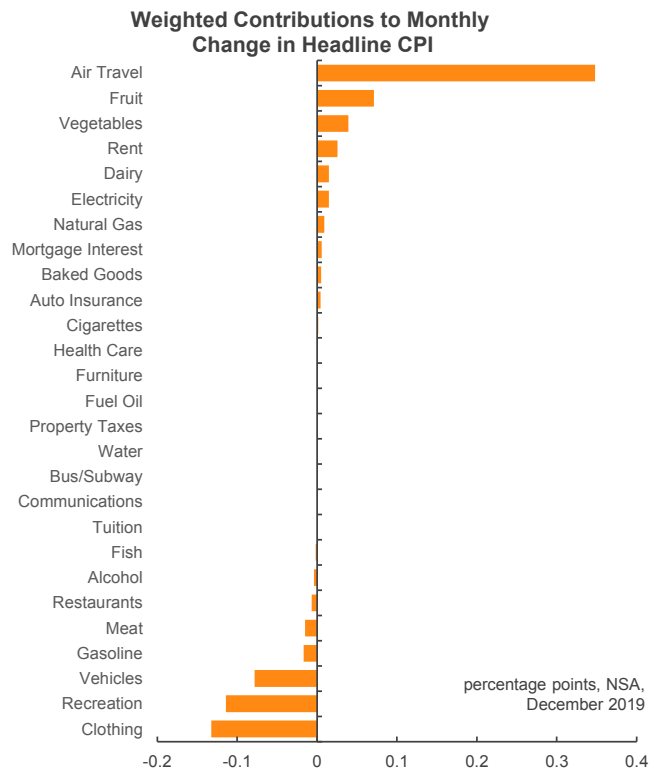
Lastly, in case you missed it, StatsCan fingered "holiday sale pricing" for a 7% m/m drop in pot prices in December. Only in Canada you might say, but the weight in CPI is trivial.

Chart 3



Source: Scotiabank Economics, Statistics Canada.

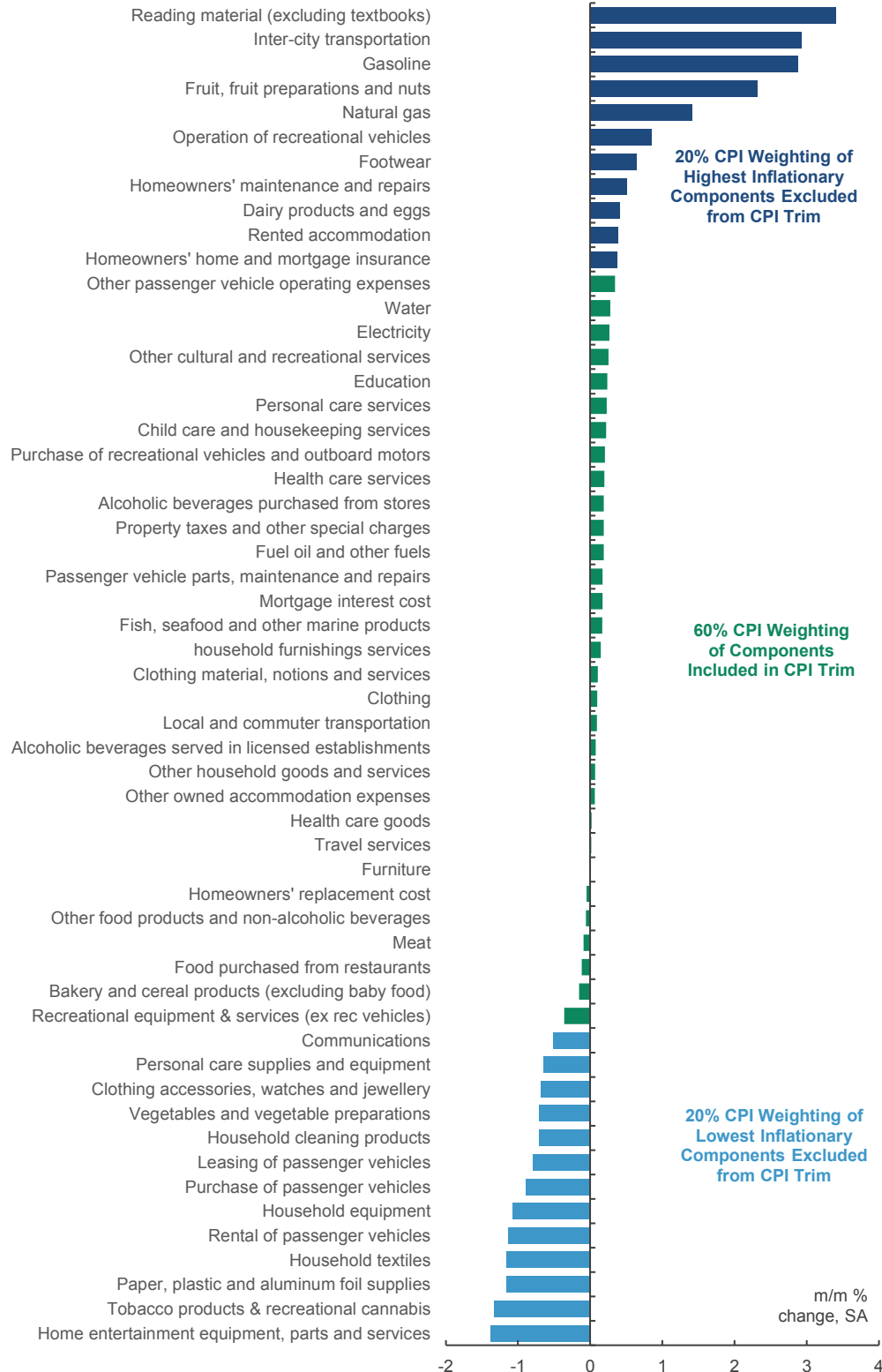
Chart 4



Source: Scotiabank Economics, Statistics Canada.

Chart 5

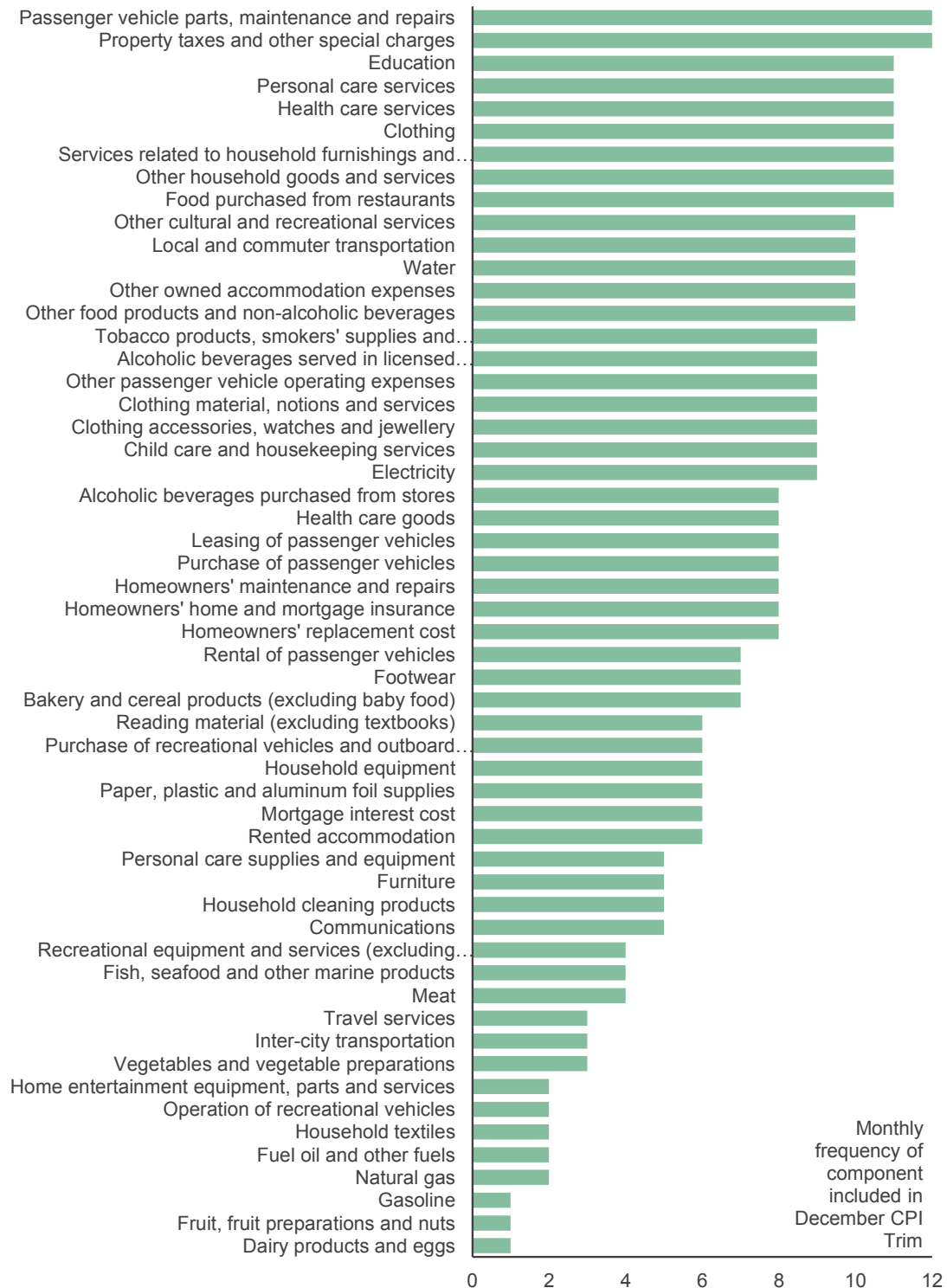
December Components Included and Excluded from Bank of Canada CPI Trim Measure



Sources: Scotiabank Economics, Statistics Canada.

Chart 6

Frequency of Components Included in Monthly Trimmed Inflation Rate Used in Calculating December's Annual CPI Trim Measure



Sources: Scotiabank Economics, Statistics Canada.

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